🌍 TRANSFER PRICING — OVERVIEW

🔹 Definition

A **transfer price** is the price charged when one **division (or subunit)** of a company sells goods or services to another **division of the same company**.

The **product or service transferred** is called an **intermediate product**.

🔹 Purpose

Used to:

- Evaluate **division performance**.
- Promote **goal congruence** (alignment between divisional and company goals).
- Ensure **fairness and motivation** among divisions.
- Support **decentralization**.

🏭 TYPES OF ORGANIZATIONS USING TRANSFER PRICING

Common in **vertically integrated companies** — i.e., those that perform multiple stages of production (e.g., Division A makes components → Division B assembles → sells to customers).

💰 KEY PRINCIPLE

While transfer pricing affects **divisional profits**, it **does not affect overall company profit** because **internal transfers are eliminated** in consolidation.

✅ Company profit = External Sales Revenue − Total Production Cost

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🎯 TRANSFER PRICING OBJECTIVES

A good transfer pricing system should:

1. Promote **goal congruence** between divisions and company.
2. Motivate **managers** to make decisions that maximize company profit.
3. Allow **fair evaluation** of each division's performance.
4. **Preserve autonomy** (important for decentralized structures).
5. Be **fair, simple, and legal**.

🌐 MULTINATIONAL TRANSFER PRICING

📜 Tax Implications

- Different countries have **different tax rates**.
- Companies could **shift income** to low-tax countries using transfer prices.
- Hence, laws like **U.S. IRC Section 482** require **arm's-length pricing** (same as between unrelated parties).

🛃 **Tariffs and Customs**

- Firms may try to **lower transfer prices** to reduce import duties.
- Customs authorities ensure prices reflect **market value**.

⚙️ TRANSFER PRICING METHODS

Method	Explanation	Advantages	Disadvantages
1. Market Price	Based on external market price (arm's length).	Objective, fair, legal.	Buying division may prefer external supplier.
2. Cost of Production + Opportunity Cost	Includes outlay cost + profit foregone (lost contribution margin).	Compensates selling division for lost profit.	Not purely market-based.
3. Variable Cost	Based only on variable production cost.	Encourages internal transfers if excess capacity.	Selling division earns no profit; not suitable if capacity is full.
4. Full Cost	Includes all materials, labor, and fixed overhead.	Easy to use; cost data readily available.	Can lead to poor decisions (includes fixed costs).
5. Cost Plus	Adds a markup to total cost (variable + fixed + S&A).	Gives seller profit; simple.	May not reflect true opportunity cost; poor cost control.
6. Negotiated Price	Price agreed by managers of both divisions.	Acceptable to both sides; flexible.	Depends on negotiation skill, not efficiency.
7. Arbitrary Price	Set by top management.	Quick; full control.	Removes divisional motivation; unfair.
8. Dual-Rate Pricing	Seller records at market price; buyer at variable cost.	Both show higher profits.	Complex; hard to evaluate true performance.

📊 CHOOSING THE BEST METHOD

Situation	Best Method	Reason
Seller has **external market**	Market price	Objective and fair
Seller has **excess capacity**	Variable cost (or variable cost + small markup)	Encourages internal transfer, increases company profit
Seller at **full capacity**	Market price (or cost + opportunity cost)	Compensates seller for lost external sales
No market price available	Cost-based or negotiated	Practical alternative
Multinational scenario	Market (arm's length) price	Complies with legal/tax rules

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🧮 SPECIAL CASE: OPPORTUNITY COST FORMULA

If the selling division is **at capacity**, internal transfer causes lost contribution margin from external sales.
Thus, **minimum transfer price** =
👉 Variable cost per unit + Opportunity cost per unit (lost CM)

If the selling division has **excess capacity**, opportunity cost = 0.
👉 Minimum transfer price = Variable cost per unit

⚖️ GOAL CONGRUENCE EXAMPLE

Case	Division A (Seller)	Division B (Buyer)	Whole Company
A sells externally	Higher CM per unit	No internal supply	OK
A sells internally below market	A earns less/unit, B earns more	✅ Both benefit if A has unused capacity	
A sells internally at market	Neutral	Neutral	✅ Aligns with external fairness

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🧠 EXAM TIPS

1. **Market-based pricing** usually yields the most goal congruence.
2. **Variable cost** is suitable only when the selling division has **idle capacity**.
3. If the selling division is a **profit/investment center**, it must be allowed to earn a **reasonable profit**.

4. **Multinational transfer prices** must satisfy **arm's-length** rules (avoid tax manipulation).
5. **Dual-rate** looks good on paper but complicates performance measurement.